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SPECIAL ANALYSIS G

TAX EXPENDITURES

The Budget of the United States Government, 1983

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SPECIAL ANALYSIS G

TAX EXPENDITURES

The Congressional Budget Act of 1974 (Public Law 93–344) requires a listing of "tax expenditures" in the budget. The act defines "tax expenditures" as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax or a deferral of tax liability." The very term "tax expenditure" is misleading in several respects, and there are formidable difficulties in trying to define the underlying concept or to measure the effect of "special" tax provisions.

Rarely, if ever, is it the case that a tax provision is actually equivalent to direct outlays by the Government for purchase of goods or services. These outlays involve a direct preemption of the production inputs used to produce the goods or services the Government buys. "Tax expenditures" never involve such a direct impact on the use of production inputs. Instead, the effect of most special tax provisions is to subsidize a particular activity. Their operation is therefore directly comparable only to those outlay programs, such as milk price supports and rent subsidies, that also provide a subsidy to particular activities. For this reason, the term "tax subsidies" is more descriptive of these special tax provisions than is "tax expenditures."

The term "tax expenditures" is also unfortunate in that it seems to imply that Government has control over all resources. If revenues which are not collected due to "special" tax provisions represent Government "expenditures," why not consider all tax rates below 100% "special," in which case all resources are effectively Government-controlled? Previous budgets have indefensibly included such items as graduated corporate tax rates and the maximum tax on earned income as if only the highest rates are "normal."

This year's analysis deals exclusively with "tax subsidies," and uses the misleading term "tax expenditures," only where that term is required by the Budget Act. The definition of tax subsidies relies on the distinction between the "normal" or "reference" provisions of the tax structure, which are necessary to make the tax operational, and the "special" provisions which are exceptions to the reference tax provisions designed to further functional program objectives, such as health care, export promotion, or employment of

the handicapped. This distinction between the reference and special provisions is not essential for tax policy purposes. For certain budget purposes, however, it is useful to distinguish between these two kinds of provisions. For example, review of housing policy would be incomplete without estimates of both direct outlays and those tax subsidies that are directed to the housing function.

The reference tax provisions are those which deal with the basic structural features of the income tax. These features include the definition of income subject to tax and allowable deductions, including cost recovery for depreciable assets; taxable units and their threshold levels of taxability; the relationship between the taxation of corporations and their shareholders; the schedule of tax rates; the basic tax accounting rules, including the accounting period for taxation and whether income is taxed as it is realized or as it accrues; the treatment of international transactions; and the system of tax administration. All of these structural features must be dealt with in some manner in order to have an operational income tax. In contrast to these reference provisions, it would be possible to have a full operational income tax which did not contain any of the special provisions which give rise to tax subsidies.

However, while the distinction between the reference and special provisions of the Code may be clear as general concepts, there are inevitable difficulties in applying these concepts to obtain a definitive list of tax subsidies. The inclusion of wages in the tax base is a clear example of reference tax structure, just as the exclusion of fringe benefits is due to special provisions, and therefore clearly constitute tax subsidies. A less clear example is provided by the capital gains provisions, which apply to a broad class of transactions and taxpayers, but which are exceptions to the general rules governing taxation of income from other sources. As explained more fully below, the capital gains provisions are considered to involve a tax subsidy.

It should be noted that other analyses of tax subsidies in the income tax have used standards quite different from the standard of the reference tax structure used here. The standard of an "ideal" income tax has often been suggested for delineating tax subsidies. However, there is no common agreement on the details of such a normative standard and many would regard such a standard as an impractical tax base. In practice, previous tax subsidy lists have not used a clear standard. Instead, they have sometimes been simply a list of possible "tax reform" items. Both the "ideal tax" and "menu of tax reforms" approaches lack the pragmatic advantage of the standard used here of identifying those provisions of the Internal Revenue Code that deal with basic structural features of the income tax, and those that provide special exceptions to those structural rules.

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Tax subsidies have objectives similar to those programs funded through direct appropriations. There are numerous examples of this. Direct expenditures and tax subsidies reduce the cost of ship acquisition by shipping companies; direct interest subsidies and the issuance of tax-exempt bonds result in lower financing costs for eligible issuers of mortgage bonds or for eligible businesses. Similarly, State and local governments benefit both from direct grant programs and from the ability to borrow funds at tax-exempt rates; individuals benefit both from direct medicare payments and from the deductibility of medical expenses for income tax purposes; and individuals also benefit both from social security payments and from the tax exemption of these payments.

This special analysis contains quantitative estimates of tax subsidies to be used in conjunction with the budget review. Like the formal listing of comparable direct outlays, the listing of specific tax subsidy items implies neither approval or disapproval of the special provisions of the tax system that authorize them. Further, distinguishing between the reference tax structure and exceptions leading to tax subsidies does not imply that features of the reference tax system as enacted should be exempt from periodic analysis and review. Many features of what is now defined as the normal tax structure, such as the rate structure, exemption levels and basic accounting rules, have major effects upon the level and composition of economic activity and the distribution of income. Although the Internal Revenue Code contains individual income, corporate income, estate and gift, excise and employment taxes that include special provisions that have expenditure program-like objectives, this analysis deals only with deviations from the reference structure in the taxation of individual and corporate income.

Defining Tax Subsidies

For a provision to involve a tax subsidy, two conditions are necessary:

—The provision must be "special" in that it applies to a narrow class of transactions or taxpayers; and

—There must be a "general" provision to which the "special" provision is a clear exception.

If these two conditions are satisfied, the special tax provision clearly has the characteristic of a direct outlay program: a program objective and a method of reimbursing program costs. Some examples will illustrate the application of these conditions to specific provisions of the Internal Revenue Code.

Under the general provisions of the income tax code, interest received from any source is includable in income subject to tax. However, a special provision allows interest on obligations of State and local governments to be excluded from taxable income. The

exclusion is therefore considered a tax subsidy. A second example is the allowance of deductions for homeowners' mortgage interest and property taxes paid. Under the general provisions of the Code, no deductions are allowed for any expenses allocable to income exempt from tax. The income from homeownership, that is, the (imputed) rental value of owner-occupied housing, is exempt from tax under the reference income tax rule requiring "realization." The special provisions which allow homeowners to reduce their housing costs by deducting mortgage interest and property taxes are therefore considered tax subsidies.

Much more difficult definitional issues are raised by the capital gains provisions. These provisions apply to a very broad class of transactions and taxpayers, and they constitute the basic provisions governing the taxation of gains from the sale of capital assets held more than one year. On these grounds it can be argued that the capital gains provisions do not involve a tax subsidy. However, under the capital gains provisions income from the sale of capital assets held more than one year is taxed in a different manner than income from any other source. Because the reference provisions for taxing income without regard to source are more general than the capital gains provisions, capital gains has been retained on the list of tax subsidies.

While the preceding examples illustrate provisions that have previously been considered tax subsidies, some items included on previous lists should not be considered tax subsidies. As noted above, graduated corporate rates and the maximum tax on earned income clearly do not involve subsidies. Another example is provided by the exclusion from the tax base of Government transfer payments, such as public assistance benefits, where there is little or no relationship between the benefit payment to the recipient and any user charge, or tax, previously paid or service performed by the recipient. Under the general provisions of the Internal Revenue Code, gifts and other receipts of payments for which no value is exchanged are specifically excluded from taxable income. Therefore, the exclusion of Government transfer payments should not be considered a tax subsidy, because the exclusion is not a special provision.

A further illustration of the definition of tax subsidies is provided by the Accelerated Cost Recovery System (ACRS) provisions enacted in the Economic Recovery Tax Act of 1981. Any income tax requires a set of rules for determining how the cost of depreciable assets is recovered. The ACRS provisions now constitute the general income tax rules for that purpose. To see this, one need only ask: If ACRS is "special," what is the "general" rule in the Internal Revenue Code governing the recovery of cost of depreciable property to which ACRS is an exception? The treatment of ACRS may be

contrasted with that of the investment tax credit, which has very similar economic effects for machinery and equipment. The investment credit is considered a tax subsidy because, unlike ACRS, it does not deal with one of the basic structural elements of an income tax. Note further that the fact that the ACRS provisions are clearly a divergence from any measure of economic income is not relevant to the determination that they do not constitute a tax subsidy.

Because they set forth general rules, the ACRS provisions are part of the reference rules, not a tax subsidy, and therefore do not appear in table G–1. They are, nevertheless, very important provisions of the reference tax structure, both because of their sizeable revenue cost ($205 million in 1981, $7,250 million in 1982, and $12,670 million in 1983), and because of their importance as investment incentives. Other items enacted in the Economic Recovery Tax Act of 1981 which are properly considered tax subsidies, including the "safe harbor" leasing provision, are included in table G–1 under the appropriate budget classification.

Several issues relating to the distinction between the reference structure of the income tax system and tax subsidy provisions are discussed in the following paragraphs.

- *Threshold income levels for tax liability.*—The reference structure includes those tax code provisions that determine threshold levels of income below which no tax liability is imposed for the different types and sizes of taxpaying units. These threshold levels have been affected by legislated changes in personal exemptions and standard deductions in recent years. However, the additional personal exemptions for taxpayers 65 and over and for the blind result in tax subsidies because they are special provisions directed at groups in special circumstances.
- *The progressive rate schedules.*—The progressive rate schedules for the individual and corporate income taxes are a part of the reference tax structure, as would be a proportional or even a regressive rate schedule. Tax subsidies do not result because some income from any source is taxed at lower rates than other income. The income averaging provision of the code for individuals is also considered to be part of the reference structure.
- *Separate rate schedules for single and married taxpayers, married taxpayers filing separately, and heads of households.*—Existing provisions regarding the definition of taxpaying units and separate rate schedules for different types of taxpayers are considered part of the reference tax structure. The concept of tax subsidies is not characterized by any specific set of rate schedules applicable to the particular tax filing

units. Similarly, the deduction for second earners enacted in the Economic Recovery Tax Act of 1981 is part of the reference tax structure.

- *Forms of business organization.*—The tax law recognizes different forms of business organization including corporations, partnerships and Subchapter S Corporations treated in a manner somewhat similar to partnerships, cooperatives, mutual insurance companies and individual proprietorships. The provisions of the tax law that accommodate different forms of business organization do not generally result in tax subsidies so long as income is subject to tax at either the corporate or the individual level.
- *Treatment of individuals and corporations as separate taxpaying entities.*—The separate taxation of individuals and regular corporate entities is part of the reference tax structure.
- *Deduction of business expenses.*—The deduction of business expenses is necessary to determine taxable income under the reference rules of the tax code. Tax subsidies, therefore, do not result when deductions for "ordinary and necessary" business expenses are taken. No attempt was made in this analysis to determine whether certain expenses such as those for entertainment and meals should not only reduce the taxable income of employers, but should also be excluded from the taxable income of the employees receiving these in-kind benefits.
- *Foreign tax credits.*—The reference structure of the income tax includes tax credits for foreign income taxes paid; this prevents the double taxation of income earned abroad.

No estimates are made in this analysis for "negative tax subsidies" or tax penalties—that is, exceptions to the reference structure of income taxes that result in increased tax liabilities for certain groups of taxpayers to discourage specified kinds of activities. At present there are only a few such exceptions. One example is the nondeductibility of gambling losses in excess of gambling gains where gambling is engaged in for profit. Also, under the Tax Reform Act of 1976 deductions for the costs associated with the demolition of certain historic buildings were disallowed, and crediting of foreign taxes paid was denied taxpayers who cooperate with, or participate in, an international boycott. These are all Government receipts normally recorded as such in the budget, or as "offsetting receipts" netted against expenditures.

Measuring Tax Subsidies

Accounting for budget outlays on a functional or programmatic basis, as in Part 5 of the *Budget*, provides measures of the extent to which the Federal Government influences the allocation of re-

sources, and for what purposes. The functional purposes may be broadly divided into (1) the provision of "public goods and services"; (2) the provision of subsidies; and (3) the payment of transfers. Budget outlays for public goods and services, such as national defense and administration of justice, are used to acquire labor and capital services directly used in production of these goods. Subsidies, such as those for school lunches and to encourage the use of U.S. flag shipping, are intended to reduce market prices below the cost of resources used to produce them. Transfers, such as aid to families with dependent children and revenue sharing are intended to provide a level of income to recipients they otherwise could not achieve.

Outlays are said to "reallocate resources" because they change the composition of GNP. The decisions to provide public goods and services, to subsidize certain prices (and hence outputs), and to make transfers directly result in producing a menu of goods and services that otherwise would not be produced because the resources to accomplish these purposes are either removed from the private sector by taxation or by borrowing. Functional budget outlay figures, then, provide a basis for evaluating programs and their total may serve as an index of the size of Government. They measure the resource cost of accomplishing the program objective, that is, outlays represent the market value of resources rechanneled, or reallocated, by Government. Since GNP is a (gross) measure of the market value of goods and services, the ratio of total budget outlays to GNP is often used as an indicator of the relative size of Government.

Whether functional budget outlay figures are used to aid in program evaluation or to provide an aggregate of outlays for evaluating the degree to which Government reallocates resources, it is essential that the outlay figures be both consistent and comprehensive measures of resource costs. In this regard, the important characteristic of market prices, the measure of resource cost, is that prices are gross of all taxes. Thus, the market value of all goods and services summarized in GNP not only includes the effects of indirect taxes (sales and property taxes) on market prices, but also the before-tax incomes of suppliers of labor (wages) and capital (rent, interest, and profit). Consistency of budget outlay figures requires that they also be stated in pre-tax magnitudes. Generally, budget outlays for the purchase of goods and services used in the provision of public goods are gross of taxes; the payments to vendors and Government employees are gross incomes of the sellers out of which taxes will be paid as determined by the reference tax laws in effect. Similarly, subsidy outlays in the budget generally enter the gross incomes of sellers of subsidized goods and services, along with the remainder of the sales proceeds realized by sellers

as payments by private purchasers of the subsidized goods. Budget outlays that are transfer payments to individuals, being nontaxable under the reference tax laws, are automatically in "pre-tax" magnitudes.

In some instances budget outlays for goods and services or subsidies are exempted from tax by a special tax provision. When this occurs, the outlay figure understates the resource cost of the program of which it is a part and is, therefore, not strictly comparable with other outlay amounts. For example, the budget outlays for certain housing and meal allowances of military personnel are not includable in their incomes and therefore understate the cost of this National Defense budget element. If this form of compensation of military personnel were treated by the generally applicable reference tax rule as income taxable to the employee, the Defense Department would have to make larger cash payments to its military personnel to leave them as well-off after-tax and to continue to attract and retain the same quantity and quality of personnel as with nontaxable allowances. The exemption from tax of these allowances involves a tax subsidy. When the tax subsidy is added to the tax-exempt budget outlay, this element of National Defense expenditure becomes comparable with other defense outlays.

Resource reallocations in the nature of subsidies and transfers may be accomplished as easily by special exceptions to reference tax law rules as by the expenditure of appropriated funds. Just as U.S. flag shipping is encouraged by outlays authorized by the Congress, U.S. flag shipping is encouraged by special income tax provisions designed to reduce shipowners' cost of acquiring ships. A review of water transportation programs would therefore be incomplete if no accounting were made of these shipping subsidies implemented through the tax system. Similarly, a Federal budget accounting of aid provided State and local governments would be incomplete if it did not include the aid provided through tax exemption of interest received by holders of bonds issued by State and local governments. Nor is a total of Federal Government expenditures which omits these tax subsidies a comprehensive accounting of the resources reallocated by Federal Government fiscal measures.

The estimates of tax subsidies in table G–1 have been prepared this year to conform them to the objectives of functional budget accounting for outlays. Unlike the estimates of prior years, the table G–1 figures are estimated as outlay *equivalents*, the magnitudes of which are consistent with direct budget outlays. The methodology used assumes that the program objective served by the special tax provision is to be achieved within all the constraints that determine market prices, and, hence, resource costs, including the rules of the reference tax structure and all other laws govern-

ing market exchanges. The estimated tax subsidy is therefore equal to the direct expenditure of funds that would be required to accomplish the same objective.

If a program is paid for with appropriated funds, the Government makes payments to individuals and corporations who perform certain stipulated acts, or qualify for transfers by reason of their characteristics, and the recipients compute their tax liability under reference tax rules, and pay that amount to the Treasury. If a program is paid for with a tax subsidy, the special tax provision in effect permits recipients to compute their tax liability as if they had received the payment, but to actually pay to the Treasury an amount equal to their tax liability *less* the payment for which they have qualified. If the program is paid for with appropriated funds, the outlay is displayed in the budget, along with the full amount of taxes actually paid; but if the program is paid for with a tax subsidy, the budget effect is registered only as a reduction in Federal tax receipts. Therefore, the entries in table G–1 may be viewed as amounts which should be both added to functional budget outlays and restored to budget receipts to provide a more consistent and comprehensive display of the resource reallocations implied by fiscal measures. Note that these adjustments leave the budget balance unaltered.

The basic difference between the new and previous tax subsidy estimates is that the new estimates account for the tax treatment of the implicit payment provided by the special tax provision. That is, the new estimates reflect the taxability of the payment under the reference tax rules. The following examples will clarify the difference in estimating technique for major classes of tax subsidies.

1. *Government outlays that are exempt from tax.*—Certain housing and meal allowances for military personnel are not included in the pre-tax incomes of military personnel, as has been noted. The former tax subsidy estimate for this item merely computed the tax that would be paid by military personnel if these payments had been taxable. The new estimates recognize that the intent of this personnel policy is to attract and retain the existing military force and that the pay equivalent taxable under reference tax law would therefore have to be sufficient to yield the same personnel an after-tax (disposable) income large enough to permit them the same housing and meal expenditure they now enjoy. Since virtually all military personnel have otherwise taxable incomes, the present estimate exceeds prior estimates which did not take account of this fact. The new tax subsidy estimate is measured in a consistent manner with other Defense Department outlays, whereas the previous estimate was not.

2. *Subsidies to reduce market prices.*—The new incremental R. & D. credit provides a subsidy for the performance of industrial R. & D. The firm qualifying for the credit is not required to include the credit in computing its taxable income, as it would were it to receive the same subsidy for R. & D. as a cash payment from the Government. Under the methodology used this year, the expenditure equivalent of the incremental R. & D. tax credit is estimated as the amont of subsidy subject to reference tax rules that would have to be paid firms for their qualified R. & D. expenditures and which would reduce their R. & D. costs by as much as the tax credit. This estimate of the R. & D. tax credit expenditure equivalent is larger than the amount that would have been estimated in previous tax subsidy budgets.

Other tax subsidies that have the effect of reducing market prices are paid by reducing the tax payments of the purchaser. For example, the deduction allowed for medical insurance obviously reduces the cost of medical insurance to the purchasers of medical insurance. Under the reference tax rules, this deduction is unrelated to the computation of individuals' (purchasers') taxable income. Further, the full expenditure of the insured taxpayer enters the taxable incomes of medical practitioners and others whose fees are thereby covered. The expenditure equivalent of this subsidy is therefore simply the reduction in tax payments of purchasers resulting from the preferential deduction. The present tax subsidy estimate for this item is therefore made in the same manner that it was previously made.

3. *Capital subsidies.*—The Government may subsidize the acquisition of capital in the private sector in either of two ways. It might provide capital grants with respect to the acquisition of specified classes of assets, or it might provide preferential loans to entities acquiring particular assets. The investment tax credit for machinery and equipment is an example of a capital grant, similar to construction subsidies paid shipowners who have ships built in U.S. shipyards, or to the furnishing of equipment to Government contractors.

In general, under the reference tax laws the beneficiary of a capital grant is regarded as not having contributed to the cost of the asset to the extent it is paid for by the Government. The asset is shown in the beneficiary's books at its net private cost. Depreciation of only the cost net of subsidy is recovered. However, in the case of the investment tax credit, the private firm is allowed cost recovery deductions for the entire cost of credited assets. Under the methodology used this year, this additional cost recovery is accounted for as an addition to the initial grant (tax credit) to derive the expenditure equivalent. Previous tax subsidy estimates have not accounted for this characteristic of the investment tax credit

and are therefore less than the expenditure equivalent reported in table G–1.

Tax deferrals resulting from special accelerated capital cost recovery allowances are a form of Government lending. For example, under reference tax rules, investments for the discovery and development of mineral deposits would be capitalized when incurred and recovered as depletion allowances as production from the deposit ensues. Under special tax rules, however, these investment expenditures are recovered as deductions when made, reducing tax liability due and payable when the investment is made and increasing tax liability due and payable in later years. The deferral of tax, as compared with the tax stream that would have occurred under reference tax rules, is in the nature of an interest-free loan. The expenditure equivalent of tax deferrals shown in table G–1 is comparable to the treatment of net lending in the outlay section of the budget. Only net new lending (deferrals) is accounted for; the subsidy element attributable to a zero interest rate on the deferral is not. Thus, the expenditure equivalents for deferral items shown in table G–1 are measured in the same way as they were in previous tax subsidy budgets.

The tax subsidy estimates reported in table G–1 have been prepared by the Treasury Department and are based upon tax law enacted as of December 31, 1981. The estimates show the expenditure equivalent of each special tax provision by fiscal year. For those tax subsidies resulting from the exclusion from taxable income of Federal Government payments to individuals, the estimates of such payments upon which the tax subsidy estimates are based are those shown elsewhere in the budget; hence they reflect any proposed changes in these programs.

The tax subsidy estimating procedure uses the same implicit assumption that governs estimates of out-year budget outlays, namely that the existing tax structure and all other institutional determinants of resource costs are given. It is also assumed that aggregate output and incomes remain at the levels that underlie the 1983 budget estimates.

The tax subsidy estimates presented in this *Special Analysis*, including those computed on a "revenue loss" basis as shown in table G–2, are *not* estimates of the increase in Federal receipts that would accompany the repeal of the special provisions that give rise to the tax subsidies. There are several reasons for these differences.

Tax subsidy estimates are based on the actual level of tax-subsidized activities; in some instances the level of these activities could be expected to change dramatically if the tax subsidy were removed. Because of these behavioral changes, the repeal revenue gain may be much lower than the tax subsidy figure. One example is the realization of capital gains, which could be expected to be

much lower if such gains were subject to tax at ordinary rates. Another example would be the response to the taxation of a particular employee fringe benefit which is currently untaxed, such as employer-paid medical insurance premiums. The expected response would be a decrease in the amount of employer-paid medical insurance premiums, but an increase in the amount of other fringe benefits, such as employers' pension contributions and educational assistance. Note that there would be analogous behavioral responses if many direct outlay programs were eliminated or curtailed. For example, the removal of a price support for a particular agricultural commodity could be expected to lead to somewhat higher production of other price-supported commodities. In such cases, the net reduction in budget outlays would be less than the savings from the eliminated (or curtailed) program.

A second reason for the difference between repeal revenue gains and tax subsidy estimates is the effect that repeal would have on the aggregate level of income and economic growth. For example, all receipts as well as expenditure figures in the budget are based on projections of income and growth which assume the investment tax credit, as currently enacted, will continue to operate. If, however, the investment credit were repealed (or curtailed) without being replaced by a comparable investment incentive, the current projections of income and growth would have to be revised downward. Consistent with these revisions, receipts and expenditure projections would also have to be revised. The estimated net effect of repeal of the investment tax credit on receipts, therefore, would not be equivalent to the tax subsidy shown here.

As is the case with estimates of proposed changes in tax law, tax subsidy estimates are computed on a "cash-flow" basis. However, for purposes of the present analysis, the estimates show the difference between tax subsidies under current law and tax subsidies under the assumption that a law without the particular tax subsidy provision had always been in effect. These figures, therefore, generally show larger amounts than would be saved in the first years of transition to a tax law without the special provisions. This is analogous to the "phase-out" likely to accompany reductions in outlay programs as previously authorized and appropriated funds are spent. The estimates take into account any changes scheduled under existing law, such as the phasing in or out of specific provisions.

Tax subsidy estimates cannot simply be added together to obtain totals for functional areas or a grand total. Simply adding tax subsidies produces inaccurate totals because certain tax subsidies affect the value of other tax subsidies. This interaction may be demonstrated by comparing the result of deleting two tax subsidies simultaneously to that of deleting them separately.

In some cases, the reduction in tax subsidies from the deletion of two tax subsidy items simultaneously would be greater than the sum of the reductions from the deletion of the two items separately. For example, if interest income from State and local government bonds were made taxable and capital gains on home sales were not deferred, more individuals would be pushed into higher tax brackets than if just one of these sources of income were treated under the normal rules of the tax code; the combined reduction in tax subsidies would be greater than the sum of the two separate effects.

In other cases, the reduction in tax subsidies from the deletion of two items together would be smaller than the sum of the reductions considered separately. For example, if the deductibility of mortgage interest payments and homeowner property taxes were both repealed and the zero bracket amount (standard deduction) were left unchanged, more individuals who now itemize their deductions would opt for the zero bracket amount than if only one preference were repealed. The reduction in tax subsidies would therefore be lower from repealing both preferences together than the sum of the two estimates obtained from repealing each one separately.

In general, elimination of several itemized deductions at one time would reduce tax subsidies by less than the sum of the reductions measured by eliminating each item separately because more taxpayers would use the zero bracket amount. Conversely, simultaneous elimination of multiple items that are exclusions from adjusted gross income would reduce tax subsidies by more than the sum of the individual reductions because more taxpayers would be pushed into higher tax brackets.

Aside from these interaction effects, resources allocated to public purposes would not necessarily be reduced by the total amount of a group of tax subsidies if all the tax subsidy provisions in that group were removed together. Tax subsidies and other provisions of tax law have frequently been changed together or viewed as substitutes for one another. Furthermore, a direct outlay may be substituted for a tax subsidy. Thus, an aggregation of tax subsidies that did take interaction into account would simply indicate the total resources available for some combination of cutting tax rates, increasing outlays, and reducing the deficit. If a group of tax subsidy provisions were removed, the overall effects on budget receipts and on resource allocation and income distribution would therefore depend on the particular decisions made as to which changes in tax rates and outlays—out of a limitless number of alternatives—were used to compensate for their removal.

Finally, although personal and corporation income tax returns continue to be the basic sources of data from which tax subsidy

estimates have been derived, the estimates are not reported separately for individuals and corporations. This is consistent with the treatment of outlays which are reported by function (or by Agency with fiscal responsibility), not by whether the payee is a person or a corporation.

Tax Subsidies by Function

Estimates of tax subsidies for 1981–83 are grouped together by functional category in table G–1. Each tax subsidy has been classified in the functional category used for budget outlays into which it most closely fits.

National defense.—The housing and meals provided military personnel, either in cash or in kind, are excluded from income subject to tax. Most of the disability related military pension income received by current retirees is also excluded.

International affairs.—A U.S. citizen or resident alien who is a resident of a foreign country or who is present in one or more foreign countries for a prescribed period is allowed special tax relief on his foreign earnings. For years prior to 1982, the prescribed period for physical presence abroad was 17 out of 18 months. The Economic Recovery Tax Act of 1981 reduced the prescribed period to 11 out of 12 months beginning January 1, 1982.

For 1980 and 1981, eligible taxpayers could deduct certain additional expenses incurred in living abroad. The deductions were for annual home leave travel, education of dependents through grade 12, a general cost of living allowance, and housing costs in excess of one-sixth of foreign earned income less the other special deductions. Taxpayers living in certain hardship areas could deduct an additional $5,000 per year. Taxpayers required to live in camps in hardship areas and individuals performing charitable services in less developed countries could elect to exclude $20,000 per year of foreign earned income instead of claiming the special deductions. These provisions did not apply to U.S. Government employees or persons paid from U.S. Government funds.

Beginning in 1982, the deductions and exclusions described in the preceding paragraph no longer apply. Under the Economic Recovery Tax Act, in 1982 eligible taxpayers may exclude $75,000 per year of foreign earned income and may exclude or deduct reasonable housing costs in excess of one-sixth of the salary of a civil servant at grade GS–14, step 1. The $75,000 exclusion increases by increments of $5,000 per year until it reaches $95,000 in 1986. These reliefs do not apply to persons who are employed by the U.S. Government; however, they do apply to persons who are not U.S. Government employees but who are paid from public funds. The tax-exempt status of certain allowances received by Federal em-

ployees working abroad has not changed. These exemptions also result in tax subsidies.

The profits of a domestic international sales corporation (DISC) are not taxed to the DISC but instead are taxed to the shareholders (usually parent corporations) when distributed or deemed distributed to them. For DISC's with more than $150,000 in otherwise taxable income, the deemed distribution equals all income attributable to base period exports plus 50% of income attributable to exports in excess of the base period exports. Base period exports equal 67% of average annual exports during an earlier 4-year base period. For DISC's with less than $100,000 in otherwise taxable income, the deemed distribution equals 50% of total income. The base-period rule is phased in for DISC's with taxable income between $100,000 and $150,000.

General science, space, and technology.—Research and development expenditures are intended to result in new products or processes, cost reductions, or other effects whose benefits will in nearly all cases continue into the future. Businesses may deduct all research and development expenditures in the year when they are incurred rather than amortize them over several years. The Economic Recovery Tax Act of 1981 added a credit for increasing research activities. The credit is equal to 15% of the increase in research expenditures over average expenditures in a base period. The base period for 1981 is 1980, for 1982 is 1980 and 1981, and for 1983 and subsequent years, the preceding 3 years. The credit expires in 1985.

Energy.—Certain capital costs necessary to discover and develop certain fuel mineral properties may be deducted as current expenses rather than amortized over the useful life of the property. Included in this category are the intangible drilling costs of oil wells, such as the wages of drilling crews, and the cost of developing other mineral deposits, such as expenditures for mine shafts, tunnels and stripping. Intangible drilling costs for oil and gas wells are a preference item for purposes of the individual's minimum tax to the extent that such costs exceed either cost depletion or 10-year amortization. However, they may exclude intangible drilling costs from their minimum tax base to the extent that the deductions did not exceed oil and gas income. The same rules apply to intangible drilling costs of geothermal wells.

Extractive industries generally use percentage depletion rather than cost depletion. Under cost depletion, actual outlays, to the extent not immediately recovered through expensing of exploration and discovery and development costs, may be deducted over the productive life of the property, much as businesses may take deductions for the depreciation of other capital goods, the cost of which

are capitalized when acquired. Percentage depletion is not likewise limited to the cost of the investment. Under percentage depletion, taxpayers may deduct a percentage of gross income from mineral production at rates ranging from 22% for oil and gas and certain other minerals to 5%; however, the deduction is limited to 50% of net income from the property or 65% of taxable income in the case of oil and gas. Percentage depletion for oil and natural gas is available only to limited quantities of output of independent oil and gas producers and royalty owners. In addition, the percentage depletion rate for oil and gas is being phased out from 22% through 1980 to 15% in 1984 and thereafter. Production from geothermal deposits is eligible for percentage depletion at the same rate as for oil and gas, but with no limit on output and no limitation with respect to qualified producers. In lieu of percentage depletion, royalties from coal deposits are treated as capital gains rather than ordinary income.

A variety of tax incentives stimulate energy conservation and encourage conversion to energy sources other than oil or natural gas. Individuals may take a 15% income tax credit for home insulation and other energy-conserving components up to a maximum credit of $300. A credit of 40% of the first $10,000 of qualifying expenditures is allowed for expenditures on solar and other renewable energy source property.

In addition to the 10% investment tax credit for machinery and equipment, a credit is allowed for business investments in specified energy property. A 10% additional credit is allowed for alternative energy property (i.e., property using fuel other than oil or natural gas, including biomass property); specially defined energy property (i.e., property used in an existing industrial, agricultural or commercial facility to reduce the amount of energy consumed or heat wasted); recycling equipment; shale oil equipment; cogeneration equipment; alumina electrolytic cells; certain intercity buses; and equipment for producing natural gas from geopressurized brine. An 11% additional credit is available for certain small-scale hydroelectric generating property, and a 15% additional credit is allowed for solar, wind, ocean thermal and geothermal equipment.

A $3 per barrel of oil-equivalent production credit is provided for several forms of alternative fuels, but, as a general rule, is not available unless the price of oil drops below $29.50 (in 1979 dollars). The credit is available without this price limitation for processed wood fuel and steam produced from solid agricultural byproducts. Gasohol is exempt from the 4 cents per gallon Federal excise tax and there is a corresponding production income tax credit for alcohol used as a fuel in applications where the excise tax is not assessed. Certain small scale hydroelectric generating facilities owned by a governmental unit and facilities which produce steam

or alcohol from solid waste may be financed with tax-exempt industrial development bonds.

Natural resources and environment.—As is true for fuel-minerals, certain capital costs associated with exploration and development of nonfuel-minerals may be expensed rather than capitalized and depreciated over the life of the asset. Most nonfuel-mineral extractors also make use of percentage depletion rather than cost depletion.

Interest on State and local government debt issued to finance the pollution control facilities of private firms is excluded from income subject to tax.

Expenditures made before January 1, 1982 to preserve and restore certain historic structures were eligible for special accelerated depreciation under prior law. This provision did not apply to owner-occupied housing.

The gains on the cutting of timber and royalties from iron ore deposits are taxed at rates applicable to long-term capital gains rather than ordinary income.

Up to $10,000 ($5,000 for a married taxpayer filing a separate return) of direct costs incurred in a taxable year to forest or reforest a site for the commercial production of timber may be amortized over a 7-year period rather than capitalized and recovered when the timber is cut. The $10,000 of costs are also eligible for the 10% investment tax credit notwithstanding the nondepreciability of investments in timber stands.

Agriculture.—Farmers, other than certain corporations and partnerships engaged in agriculture, are allowed to deduct certain costs as current expenses even though these expenditures are for inventories held at the end of the year or for capital improvements that are required to be capitalized under reference income accounting. Capital gains treatment generally applies to the sale of livestock and certain other agriculture products.

Commerce and housing credit.—This category includes a number of tax subsidy provisions that also affect economic activity in other functional categories. In general, provisions related to investment, such as the investment tax credit, might alternatively have been classified under the natural resources and environment, energy, agriculture, or transportation categories.

An exclusion of $200 ($400 on a joint return) is allowed for most dividend and interest income. Under the Economic Recovery Tax Act of 1981, beginning in 1984 the exclusion is reduced to $100 ($200 on a joint return) and is applicable only to dividend income.

The interest on industrial development bonds issued by State and local governments is excluded from income subject to tax.

Credit unions are exempt from Federal income taxes. Commercial banks, mutual savings banks, and savings and loan associations are permitted to deduct additions to bad debt reserves in excess of actual loss experience and reasonable expectations as to future losses. Mutual savings banks and savings and loan associations may deduct 40% of income provided they maintain stipulated fractions of their assets in "qualifying assets," primarily residential mortgages.

Life insurance policies other than term policies generally contain a savings element. Savings in the form of policyholder reserves are accumulated from premium payments and interest is earned on the reserves. Such interest income is taxable neither as it accrues nor when received by beneficiaries.

Interest paid on consumer credit is allowed as an itemized deduction for individuals.

Owner-occupants of homes may deduct mortgage interest and property taxes (but not maintenance outlays or depreciation) as itemized nonbusiness deductions.

Interest on State and local government debt issued to finance below-market rate mortgages for owner-occupied housing is excluded from income subject to tax. The Omnibus Budget Reconciliation Act of 1980 restricts the use of mortgage subsidy bonds with a State-by-State ceiling on the annual volume of such use for single family housing equal to 9% of the average of all mortgages that originated in the State during the preceding 3 years of $200 million, whichever is greater. A total ban on mortgage subsidy bonds for single family housing becomes effective January 1, 1984.

Prior to the Tax Reform Act of 1976, taxpayers deducted interest and property tax payments made while a building was under construction rather than following the general rule of the code which requires that all costs of a depreciable asset be capitalized and be recovered over its recovery period. The 1976 act reduced this tax subsidy by requiring that construction period interest and taxes be capitalized and recovered over a 10-year period for noncorporate taxpayers. The provision is being phased in over a 7-year period with more generous transition rules available for housing projects receiving direct expenditure subsidies under Government housing programs. However, the Economic Recovery Tax Act of 1981 excepted from the construction period phase-in, interest and taxes on low-income housing, which can be expensed.

Sixty percent of net long-term gains from the sale of capital assets may be excluded from income. The excluded 60% of net long-term gains is no longer included as a preference item in computing the minimum tax for individuals. However, the capital gains exclusion is treated as a preference item in the "alternative minimum tax." This tax is applicable only if the sum of a taxpay-

er's regular income and minimum tax is less than his alternative minimum tax. Half of net long-term capital losses and 100% of net short-term capital losses may be offset against ordinary income up to a maximum deduction of $3,000 per year with an unlimited carryforward. Under the Economic Recovery Tax Act of 1981, net capital gains from sales or exchanges occurring after June 9, 1981 are taxed at a maximum rate of 20%. This maximum rate is equal to the 40% inclusion rate times the maximum individual rate that will apply after 1981 of 50%.

Corporations may elect a 28% alternative tax rate on capital gains. The tax subsidy is estimated on the assumption that these gains would otherwise be taxed at ordinary rates.

Capital gains on the sale of a home are recognized only to the extent that the "adjusted sales price" exceeds the cost of a new home purchased and occupied within 2 years (increased from 18 months by the Economic Recovery Tax Act of 1981) before or after the sale. If a new house is constructed, it must be occupied within 2 years after the sale. The "adjusted sales price" is the amount realized (gross proceeds less selling expenses) minus qualified "fixing up" expenses. To the extent that the gain on the sale of a home is not recognized, the basis of the home purchased is reduced, thereby resulting in a deferral of the gain. A loss on the sale of a home is not deductible.

A taxpayer who is 55 years of age or older at the time of the sale of his principal residence may elect to exclude up to $125,000 (increased from $100,000 by the Economic Recovery Tax Act of 1981) of gain from the sale. This is a once in a lifetime election.

The gain on the sale of capital assets acquired by inheritance is computed as the excess of the sale price over their value at the time of the original owner's death, rather than as the excess over their value at the time of acquisition by the original owner. The estimate assumes that the difference in the computed gain would be taxed as part of the capital gain in the year of sale.

The 10% investment tax credit is applied to the cost of qualifying property (generally, tangible, depreciable personal property used in a trade or business) in the 5-, 10-, and 15-year recovery classes under the Accelerated Cost Recovery System (ACRS). Assets in the 3-year recovery class are entitled to a 6% credit. Notwithstanding the reduction in cost of acquiring qualified property provided by the credit, taxpayers may recover the original cost gross of the credit. As a general rule, the credit cannot be claimed for investments in land or buildings or for property used abroad. The investment tax credit may be claimed as progress payments are made on property that takes 2 or more years to construct. Prior to the Revenue Act of 1978, the maximum credit allowed against income tax liability in a taxable year was generally limited to $25,000 plus

50% of tax liability in excess of $25,000. The 1978 act raised the excess liability percentage to 60% for 1979 and increases it through annual increments of 10 percentage points to 90% by 1982. Before enactment of the Economic Recovery Tax Act of 1981, excess credits could generally be carried back 3 taxable years and forward 7 taxable years, after which unused credits expired. The 1981 Act extended the carry-forward period to 15 years.

The 1981 act also provided "safe harbors" for tax leases of business machinery and equipment. Under these leases, depreciation and the investment tax credit are normally claimed by the lessor, although the lessee is the actual user and owner of the machinery or equipment.

The Economic Recovery Tax Act of 1981 allows financial institutions to issue special 1-year certificates until December 31, 1982, that pay tax-exempt interest. The interest rate on the certificates issued during any week is limited to 70% of the interest rate on the last 52-week Treasury bills issued in a preceding week. The total amount of interest that is exempt on these certificates for an individual is limited to $1,000 ($2,000 on a joint return). Financial institutions must invest at least 75% of the proceeds from these certificates in housing or agricultural loans.

The Economic Recovery Tax Act of 1981 allows public utilities between 1982 and 1985 to distribute stock in lieu of cash dividends to shareholders who may then deduct up to $750 per year ($1,500 on a joint return) of the stock dividends.

Transportation.—Certain companies that operate U.S.-flag vessels receive an indefinite deferral of income taxes on that portion of their income which is used for shipping purposes, primarily construction, modernization and major repairs of ships. An investment credit of one-half the regular credit may be claimed on the tax-deferred amounts withdrawn from capital construction funds.

The Economic Recovery Tax Act of 1981 allows State and local governments to issue tax-exempt obligations to finance the purchase of mass commuting vehicles.

Community and regional development.—Under certain conditions, taxpayers may elect to amortize rehabilitation expenditures for low- and moderate-income rental housing over a 5-year period. Rehabilitation expenditures may not exceed $20,000 per dwelling unit and must exceed $3,000 to qualify. The Economic Recovery Tax Act of 1981 increased the limit to $40,000 per dwelling unit if the rehabilitation is on units which the tenants may purchase at a price that limits the profit to the seller. This provision expires on January 1, 1984.

The Economic Recovery Tax Act of 1981 also provides an investment tax credit for the rehabilitation of buildings that are used for

business or productive activities (other than for residential purposes). The credit is 15% of rehabilitation expenditures for buildings at least 30 years old and 20% for buildings at least 40 years old. The basis of the rehabilitation recoverable as depreciation must be reduced by the amount of the credit. In addition, a 25% credit for rehabilitation of historic structures, including rental residential properties, was added by the 1981 act. Under prior law, a 10% credit was allowed for buildings at least 20 years old, with no reduction in basis.

Education, training, employment, and social services.—Interest on State and local government debt issued to finance student loans is excluded from income subject to tax.

Taxpayers may claim personal exemptions for dependent children 19 or over who receive income of $1,000 or more per year if the children are full-time students. The student may also claim an exemption on his own return, thus providing a double exemption. The extra exemption for parents results in a tax subsidy.

Many employers provide employee benefits that are excluded from employee income. The employers' costs for these benefits are deductible business expenses. The exclusion from an employee's income of the value of meals and lodgings provided by an employer for his own convenience is a tax subsidy, as is the exclusion of housing allowances and the rental value of parsonages from the taxable income of ministers. An employer may set up an educational assistance program to provide educational benefits to his employees from January 1, 1979, through December 31, 1983. The program can pay for tuition, fees, books, and supplies. Amounts received under the program are excluded from an employee's gross income. Employer contributions to prepaid legal services plans and the value of legal services received under the plans are also excluded from employee income.

For qualifying investment made prior to January 1, 1983, a corporation may claim an additional 1% investment tax credit if an equivalent amount of its common stock is set aside in a employee stock ownership plan (ESOP). A further one-half of 1% investment tax credit may be claimed to the extent that additional employer contributions to an ESOP are matched by employee contributions. Under the Economic Recovery Tax Act of 1981, the tax credit for contributions to an ESOP is limited to a prescribed percentage of total compensation paid to all employees under the plan. The percentage is one-half of 1% in 1983 and 1984, and three-quarters of 1% in 1985, 1986, and 1987. The ESOP credit expires in 1987. Employees are generally prohibited from withdrawing their share of an ESOP for 7 years.

Contributions to charitable, religious and certain other nonprofit organizations are allowed as an itemized deduction for individuals,

generally up to 50% of adjusted gross income. The Economic Recovery Tax Act of 1981 provides that nonitemizers may deduct a portion of charitable contributions, beginning in 1982. Taxpayers whose contributions to charitable or educational organizations are in the form of capital assets, usually securities that have appreciated in value above their cost, obtain a deduction for the contribution at the appreciated value of the asset without taxation on the appreciation in value. Corporations may deduct charitable contributions of up to 5% of their income. The deduction is increased to 10%, beginning in 1982, by the Economic Recovery Tax Act of 1981. Tax subsidies resulting from the deductibility of contributions are shown separately here for contributions to educational and other institutions. Contributions to health institutions are reported under the health function.

A 20% tax credit may be claimed by married couples for child and dependent care expenses incurred when both spouses work full time or when one spouse works part time or is a student. The credit may also be claimed by divorced or separated parents who have custody of children and by single parents. Expenditures up to a maximum of $2,000 for one dependent and $4,000 for two or more dependents are eligible for the 20% credit. The credit may be taken for payments to relatives of the taxpayer even if their services are not qualified for coverage under the social security laws. Under the Economic Recovery Tax Act of 1981, beginning in 1982, the credit is increased to 30% for taxpayers with incomes of $10,000 or less with the credit reduced by one percentage point for each $2,000 of income between $10,000 and $28,000, expenditures for out-of-home noninstitutional care of a disabled spouse or dependent are eligible for the credit, and the limits on eligible expenditures are raised to $2,400 for one dependent and $4,800 for two or more. Note that in the absence of the credit, expenses for child and dependent care would be deductible as employee business expenses. Therefore, the estimates reflect the excess of the value of the credit over the value of a deduction.

The targeted jobs credit allows tax credits for qualified wages paid to individuals certified as members of a targeted group. The Economic Recovery Tax Act of 1981 eliminated the AFDC–WIN credit, but made individuals who qualified under that credit—those employed under the WIN (work incentive) program and other recipients of AFDC (Aid to Families with Dependent Children)—eligible for the targeted jobs credit. A credit of 50% of first-year wages and 25% of second-year wages up to $6,000 of each employee's wages (the wage base for unemployment taxes) can be taken by the employer to offset up to 90% of his tax liability. The provision that the credit may not be taken for first-year wages in excess of 30% of the employer's total unemployment tax wage base was removed by

the Economic Recovery Tax Act of 1981. The employer's deduction for wages is reduced by the amount of the credit.

Health.—Payments by employers for health insurance premiums and other medical expenses are deducted as business expenses by employers and excluded from employee income. The exclusion from employee income gives rise to a tax subsidy.

Medical expenses in excess of 3% of adjusted gross income, including payments for prescribed drugs and medicines in excess of 1% of adjusted gross income, may be deducted by individuals as itemized nonbusiness deductions. Individuals may also deduct half of the premiums they pay for medical care insurance up to a maximum deduction of $150 per year without regard to the 3% limit.

Interest on State and local government debt issued to finance hospital construction is excluded from income subject to tax.

Expenditures up to $25,000 per year for removing architectural and transportation barriers to the handicapped and the elderly in any facility or public transportation vehicle used in a trade or business that otherwise would have been treated as a capital outlay can be treated as a current expense prior to January 1, 1983.

Contributions to nonprofit health institutions are allowed as a deduction for individuals and corporations. Contributions to other charitable institutions are discussed under the education, training, employment, and social services function.

Income security.—Most Government transfer payments to individuals, such as social security benefits, are excluded from taxable income. If the taxpayer had no other source of income, these payments, even if taxable, would not generally be large enough to result in tax liability, given present levels of personal exemptions and the zero bracket amount. However, because some recipients have property income, receive earnings (in some instances for only part of a year), or file jointly with working spouses, tax subsidies result from these exclusions.

If the sum of a taxpayer's adjusted gross income, unemployment compensation and excludable disability income is over $20,000 ($25,000 for a joint return), the lesser of his unemployment benefits or one-half of the amount over the $20,000 limit is taxable.

Certain payments up to $100 per week financed by an employer in lieu of wages during periods of employee injury or sickness are excluded from the taxable income of persons under the age of 65, who are permanently and totally disabled. For these individuals the exclusion is reduced dollar for dollar by adjusted gross income plus disability income in excess of $15,000.

Certain contributions to pension plans by employers and amounts set aside by the self-employed and those not covered by an employer's plan are excluded from the individual's adjusted gross

income in the year of contribution. Self-employed persons could make deductible contributions to their own retirement plans equal to 15% of their income up to a maximum of $7,500 per year. Employees not covered by an employer's plan could deduct annual contributions of 15% of compensation up to a maximum of $1,500 or $1,750 if the retirement account was owned jointly by a husband and wife. Under the Economic Recovery Tax Act of 1981, beginning in 1982 the maximum deductible contribution for self-employed persons is $15,000. For employees, the requirement that they not be covered by an employer's plan was removed, and the maximum was raised to $2,000 (or 100% of compensation, if less) for each employee or $2,250 on a joint return if one spouse has no compensation. The investment income earned by pension funds is not taxable when earned.

The exclusion from employee income of certain other employer payments, including payments for premiums of group life insurance and accident and disability insurance, are listed here because of their relationship to income security. The exclusion of certain other fringe benefits is listed under the education, training, employment, and social services function.

Additional personal exemptions of $1,000 may be taken by taxpayers who are 65 years of age or older or blind. These additional exemptions may not be claimed for a taxpayer's dependents.

The retirement credit for the elderly allows individuals who are 65 years of age or older to take a tax credit equal to 15% of earned and retirement income up to $2,500 for single individuals and married couples filing a joint return where only one spouse is 65 years of age or older, and up to $3,750 for joint returns where both spouses are 65 years of age of older. The $2,500/$3,750 base is reduced by one-half of the taxpayer's adjusted gross income over $7,500 for single individuals and $10,000 for married couples filing a joint return.

Taxpayers generally may take as an itemized nonbusiness deduction each loss due to fire, theft or other casualty in excess of $100 to the extent not compensated by insurance or other payments.

The earned income credit, which low-income workers with minor dependents may claim, is 10% of earned income up to $5,000 with a phase-out at the rate of 12.5% per dollar earned over $6,000. The maximum annual credit is $500.

Earned income tax credits in excess of tax liabilities are paid to individuals. This portion of the credit is included in outlays while the amount that offsets tax liabilities is included as a tax subsidy.

Rental housing assistance is provided through State and local housing authorities for eligible families. The Omnibus Budget Reconciliation Act of 1980 restricts the use of tax-exempt bonds for multifamily rental housing projects to those that include a substan-

tial number of units for low- and moderate-income individuals. The restrictions apply to such bonds issued after April 25, 1979 with exceptions allowed for bonds in process as of that date.

The Economic Recovery Tax Act of 1981 allows an itemized deduction of up to $1,500 for expenses incurred in the adoption of children with special needs. The act also allows a 5-year write-off of the loss in value of motor carrier operating authorities due to deregulation of the industry.

Veterans benefits and services.—All compensation due to death or disability and pensions paid by the Veterans Administration are excluded from taxable income. GI bill benefits are also excluded.

General government.—A 50% credit may be claimed on political contributions up to $100 ($200 for joint returns).

General purpose fiscal assistance.—Interest on State and local government debt is excluded from Federal taxation. Both corporations, mainly commercial banks, and individuals receive this tax exempt income. As a result, these governments can sell debt obligations at a lower interest cost than would be possible if such interest were subject to tax. The exclusion of interest on State and local government securities issued to finance pollution control facilities, other industrial development bonds, and housing bonds is classified elsewhere. Only the effect of excluding interest on general purpose obligations and revenue bonds for public purposes such as toll roads is included in this function.

The deductibility of nonbusiness State and local taxes gives indirect assistance to these governments. The estimates shown here are primarily for the deductibility of State and local income and sales taxes. The deductibility of property taxes on owner-occupied homes is classified under commerce and housing credit.

Under certain conditions, U.S. corporations receiving income from sources in a U.S. possession can claim a special tax credit equal to the U.S. tax, but only on income from such sources.

Interest.—The interest on U.S. savings bonds is not taxable until the bonds are redeemed, thereby deferring tax liability.

Table G–1. OUTLAY EQUIVALENT ESTIMATES FOR TAX SUBSIDIES BY FUNCTION

(In millions of dollars)

Description	Fiscal years		
	1981	1982	1983
National defense:			
Exclusion of benefits and allowances to Armed Forces personnel	2,365	2,335	2,450
Exclusion of military disability pensions	160	165	165
Total (after interactions)	2,525	2,500	2,615
International affairs:			
Exclusion of income earned abroad by United States citizens	1,045	1,850	2,155
Deferral of income of domestic international sales corporations (DISC)	2,790	2,750	2,775
Total (after interactions)	3,835	4,600	4,930
General science, space, and technology:			
Expensing of research and development expenditures	760	730	−1,260
Credit for increasing research activities	205	650	1,060
Total (after interactions)	1,060	1,515	−220
Energy:			
Expensing of exploration and development costs:			
Oil and gas	4,725	5,195	5,595
Other fuels	40	45	45
Excess of percentage over cost depletion:			
Oil and gas	3,110	2,855	2,325
Other fuels	540	550	615
Capital gains treatment of royalties on coal	195	160	145
Exclusion of interest on State and local government industrial development bonds for certain energy facilities	*	5	15
Residential energy credits:			
Supply incentives	230	295	365
Conservation incentives	560	540	520
Alternative, conservation and new technology credits:			
Supply incentives	235	315	380
Conservation incentives	285	370	400
Alternative fuel production credit	60	120	65
Alcohol fuel credit [1]	5	25	50
Energy credit for intercity buses	5	5	10
Total (after interactions)	8,475	8,830	8,800
Natural resources and environment:			
Expensing of exploration and development costs, nonfuel minerals	75	85	90
Excess of percentage over cost depletion, nonfuel minerals	555	595	640
Exclusion of interest on State and local government pollution control bonds	745	875	1,010
Tax incentives for preservation of historic structures	70	80	75
Capital gains treatment of iron ore	40	35	30
Capital gains treatment of certain timber income	1,050	1,065	1,080
Investment credit and seven-year amortization for reforestation expenditures	10	20	30
Total (after interactions)	2,510	2,705	2,910
Agriculture:			
Expensing of certain capital outlays	530	550	570
Capital gains treatment of certain income	710	635	555
Total (after interactions)	1,315	1,250	1,180
Commerce and housing credit:			
Dividend and interest exclusion	3,350	1,570	650
Exclusion of interest on State and local industrial development bonds	1,310	1,785	2,340
Exemption of credit union income	−50	25	60
Excess bad debt reserves of financial institutions	420	550	1,030
Exclusion of interest on life insurance savings	6,255	6,625	6,775
Deductibility of interest on consumer credit	8,790	9,325	9,345
Deductibility of mortgage interest on owner-occupied homes	20,595	23,275	25,775

Table G–1. OUTLAY EQUIVALENT ESTIMATES FOR TAX SUBSIDIES BY FUNCTION—Continued

(In millions of dollars)

Description	Fiscal years		
	1981	1982	1983
Deductibility of property tax on owner-occupied homes	9,270	9,945	10,490
Exclusion of interest on State and local housing bonds for owner-occupied housing	730	1,020	1,335
Expensing of construction period interest and taxes	775	710	615
Capital gains (other than agriculture, timber, iron ore and coal)	33,240	25,060	22,180
Deferral of capital gains on home sales	1,550	1,640	2,120
Exclusion of capital gains on home sales for persons age 55 and over	600	635	820
Carryover basis of capital gains at death	3,355	3,220	3,325
Investment credit, other than ESOP's, rehabilitation of structures, energy property, and reforestation expenditures	24,640	24,250	27,005
Safe harbor leasing rules	1,510	3,065	4,600
Amortization of start-up costs	70	135	215
Exclusion of interest on certain savings certificates	.....	1,660	2,805
Reinvestment of dividends in public utility stock	.....	400	590
Total (after interactions)	117,470	114,355	120,910
Transportation:			
Deferral of tax on shipping companies	65	70	90
Exclusion of interest on State and local government bonds for mass transit	.....	*	15
Total (after interactions)	65	70	105
Community and regional development:			
Five-year amortization for housing rehabilitation	35	45	60
Investment credit for rehabilitation of structures	240	390	315
Total (after interactions)	275	435	375
Education, training, employment, and social services:			
Exclusion of interest on State and local student loan bonds	70	115	170
Parental personal exemption for students age 19 or over	1,025	1,020	1,020
Exclusion of employee meals and lodging (other than military)	695	730	755
Employer educational assistance	45	55	55
Exclusion of contributions to prepaid legal services plans	30	30	30
Investment credit for ESOP's	1,730	1,910	2,015
Deductibility of charitable contributions (education)	910	900	940
Deductibility of charitable contributions, other than education and health	8,550	8,295	8,095
Credit for child and dependent care expenses	1,390	1,755	2,020
Credit for employment of AFDC recipients and public assistance recipients under work incentive programs	115	30	*
General jobs credit	200	30	.....
Targeted jobs credit	250	385	200
Total (after interactions)	15,370	15,620	15,665
Health:			
Exclusion of employer contributions for medical insurance premiums and medical care	19,215	20,615	21,455
Deductibility of medical expenses	3,670	3,950	4,210
Exclusion of interest on State and local hospital bonds	590	715	845
Deductibility of charitable contributions (health)	1,395	1,355	1,355
Total (after interactions)	25,110	26,895	28,135
Income security:			
Exclusion of social security benefits:			
Disability insurance benefits	880	920	910
OASI benefits for retired workers	9,105	10,130	10,595
Benefits for dependents and survivors	1,785	1,935	1,975
Exclusion of railroad retirement system benefits	370	375	375
Exclusion of workmen's compensation benefits	2,755	3,165	3,520
Exclusion of special benefits for disabled coal miners	95	90	90
Exclusion of untaxed unemployment insurance benefits	2,010	2,565	2,250

Table G–1. OUTLAY EQUIVALENT ESTIMATES FOR TAX SUBSIDIES BY FUNCTION—Continued

(In millions of dollars)

Description	Fiscal years		
	1981	1982	1983
Exclusion of disability pay	210	190	170
Net exclusion of pension contributions and earnings:			
Employer plans	34,230	36,695	37,885
Plans for self-employed and others	3,660	5,030	5,820
Exclusion of other employee benefits:			
Premiums on group term life insurance	2,485	2,545	2,475
Premiums on accident and disability insurance	140	140	130
Income of trusts to finance supplementary unemployment benefits	15	20	20
Additional exemption for the blind	30	30	30
Additional exemption for elderly	2,250	2,355	2,370
Tax credit for the elderly	130	135	135
Deductibility of casualty losses	1,100	1,125	1,165
Earned income credit [2]	690	525	500
Exclusion of interest on State and local housing bonds for rental housing	455	500	565
Deduction for motor carrier operating rights	95	115	115
Deduction for certain adoption expenses	15	15	15
Total (after interactions)	64,070	70,295	72,850
Veterans benefits and services:			
Exclusion of veterans disability compensation	1,290	1,405	1,405
Exclusion of veterans pensions	95	85	90
Exclusion of GI bill benefits	205	180	150
Total (after interactions)	1,605	1,685	1,660
General government:			
Credits and deductions for political contributions	85	80	80
General purpose fiscal assistance:			
Exclusion of interest on general purpose State and local debt	6,100	6,925	7,740
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	19,345	20,470	21,680
Tax credit for corporations receiving income from doing business in United States possessions	2,110	2,260	2,425
Total (after interactions)	27,755	29,860	32,060
Interest:			
Deferral of interest on savings bonds	480	620	710

*$5 million or less. All estimates have been rounded to the nearest $5 million.

[1] In addition, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts of $55 million in 1981, $55 million in 1982, and $55 million in 1983.

[2] The figures in the table indicate the tax subsidies provided by the earned income tax credit. The effect on outlays is: 1981, $1,320 million; 1982, $1,255 million; 1983, $1,180 million.

Proposed Changes in Tax Subsidies

The administration has proposed a number of tax revisions that would remove or reduce the value of existing tax subsidies. The revisions include the repeal of business energy tax credits, restrictions on tax-exempt bonds for private activities, capitalization of construction period interest and taxes incurred by corporations, and a new corporate minimum tax. These revisions are described briefly below, including estimates of their impact on 1983 receipts.

Repeal Business Energy Tax Credits.—Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Some energy tax credits expire at the end of 1982, but others extend through 1985 and beyond. Current law also provides an excise tax exemption, or an equivalent tax credit, for gasohol.

With decontrol of oil and some natural gas prices, businesses no longer need additional investment incentives for energy conservation and development of alternative energy sources. Such subsidies interfere with business decisions by preempting free market resource allocations.

Effective January 1, 1983, the administration proposes to repeal all business energy tax subsidies and to repeal special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

The repeal of these provisions will increase 1983 receipts by $0.1 billion.

Restrict Tax-Exempt Bonds for Private Activities.—Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other specific purposes. The volume of tax-exempt bonds issued for use by private business has grown rapidly over the past few years, raising the cost of financing traditional public projects such as schools and roads. There is no requirement under current law that industrial development bonds serve a genuine public purpose. In addition, tax-exempt financing combined with Accelerated Cost Recovery and the investment tax credit can result in unintended tax benefits.

The administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over an extended recovery period. Tax-exempt financing will be limited to bonds that are publicly approved by local governments and which, after 1985, receive a financial contribution or commitment from the local government. Small issue

industrial development bonds will not be allowed for large businesses.

These restrictions on tax-exempt bonds for private activities will encourage anticipatory issues in 1982 and, therefore, reduce 1983 receipts by $0.2 billion. There will be an increase in receipts in 1984 and subsequent years.

Capitalization of Construction Period Interest and Taxes.—Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial buildings and deduct those costs over 10 years. The write-off period for rental housing is 8 years, but is scheduled to become 10 years by 1984. However, for corporations, the law permits an immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

The administration proposes that construction period interest and taxes incurred by corporations to develop real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. Low-income housing will be exempted, as under present law.

This proposal will increase 1983 receipts by $0.5 billion.

Corporate Minimum Tax.—Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15% of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

The administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax that would apply only to those corporations that pay very low regular rates of tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15% of their alternative tax base in excess of $50,000. This alternative tax base consists of regular taxable income plus certain tax preferences. The investment tax credit will not be allowed against the alternative tax.

This new corporate minimum tax will increase 1983 receipts by $2.3 billion.

Revenue Loss Estimates for "Tax Expenditures"

Table G–2, which follows, shows the estimated "revenue loss" associated with each tax subsidy item for which an "outlay equivalent" estimate was provided in table G–1. As explained in the text under the heading "Measuring Tax Subsidies," revenue loss estimates do not take into account the additional resources (if any) that would be required to provide the same after-tax incentive if

the expenditure program were administered as a direct outlay rather than through the tax system. As was also previously explained, these "revenue loss" estimates, for several reasons, are *not* equivalent to estimates of the increase in Federal receipts that would accompany the repeal of tax subsidy provisions.

Table G–2. REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" BY FUNCTION

(In millions of dollars)

Description	Fiscal years		
	1981	1982	1983
National defense:			
Exclusion of benefits and allowances to Armed Forces personnel	1,735	1,885	1,940
Exclusion of military disability pensions	155	165	170
International affairs:			
Exclusion of income earned abroad by United States citizens	610	985	1,285
Deferral of income of domestic international sales corporations (DISC)	1,595	1,465	1,490
General science, space, and technology:			
Expensing of research and development expenditures	1,550	380	−810
Credit for increasing research activities	15	405	580
Energy:			
Expensing of exploration and development costs:			
Oil and gas	3,525	4,065	4,530
Other fuels	25	25	30
Excess of percentage over cost depletion:			
Oil and gas	1,865	1,965	1,695
Other fuels	380	380	425
Capital gains treatment of royalties on coal	100	105	95
Exclusion of interest on State and local government industrial development bonds for certain energy facilities	•	5	15
Residential energy credits:			
Supply incentives	150	205	260
Conservation incentives	425	415	410
Alternative, conservation and new technology credits:			
Supply incentives	180	235	290
Conservation incentives	220	285	315
Alternative fuel production credit	25	55	50
Alcohol fuel credit [1]	5	20	35
Energy credit for intercity buses	5	5	5
Natural resources and environment:			
Expensing of exploration and development costs, nonfuel minerals	45	50	55
Excess of percentage over cost depletion, nonfuel minerals	385	405	440
Exclusion of interest on State and local government pollution control bonds	715	835	970
Tax incentives for preservation of historic structures	60	80	75
Capital gains treatment of iron ore	20	20	20
Capital gains treatment of certain timber income	585	600	615
Investment credit and seven-year amortization for reforestation expenditures	5	10	15
Agriculture:			
Expensing of certain capital outlays	525	545	560
Capital gains treatment of certain income	425	460	375
Commerce and housing credit:			
Dividend and interest exclusion	1,335	2,185	475
Exclusion of interest on State and local industrial development bonds	1,200	1,650	2,185
Exemption of credit union income	−25	5	40
Excess bad debt reserves of financial institutions	325	250	515
Exclusion of interest on life insurance savings	4,060	4,535	4,805
Deductibility of interest on consumer credit	8,675	9,285	9,355
Deductibility of mortgage interest on owner-occupied homes	20,145	23,030	25,490
Deductibility of property tax on owner-occupied homes	9,125	10,065	10,635
Exclusion of interest on State and local housing bonds for owner-occupied housing	685	920	1,245
Expensing of construction period interest and taxes	755	745	645
Capital gains (other than agriculture, timber, iron ore and coal)	17,965	18,315	14,390
Deferral of capital gains on home sales	1,160	1,070	1,200

Table G–2. REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" BY FUNCTION—Continued

(In millions of dollars)

Description	Fiscal years		
	1981	1982	1983
Exclusion of capital gains on home sales for persons age 55 and over	450	415	465
Carryover basis of capital gains at death	2,070	2,190	2,135
Investment credit, other than ESOP's, rehabilitation of structures, energy property, and reforestation expenditures	19,445	20,035	20,150
Safe harbor leasing rules	*	3,560	3,945
Amortization of start-up costs	20	75	120
Exclusion of interest on certain savings certificates		515	2,820
Reinvestment of dividends in public utility stock	*	130	365
Transportation:			
Deferral of tax on shipping companies	70	65	85
Exclusion of interest on State and local government industrial development bonds for mass transit		*	5
Community and regional development:			
Five-year amortization for housing rehabilitation	30	45	55
Investment credit for rehabilitation of structures	220	255	300
Education, training, employment, and social services:			
Exclusion of interest on State and local student loan bonds	60	100	155
Parental personal exemption for students age 19 or over	1,045	995	900
Exclusion of employee meals and lodging (other than military)	620	655	680
Employer educational assistance	35	40	40
Exclusion of contributions to prepaid legal services plans	20	20	25
Investment credit for ESOP's	975	1,005	1,095
Deductibility of charitable contributions (education)	925	895	925
Deductibility of charitable contributions, other than education and health	8,485	8,345	8,085
Credit for child and dependent care expenses	935	1,120	1,465
Credit for employment of AFDC recipients and public assistance recipients under work incentive programs	70	45	*
General jobs credit	300	65	5
Targeted jobs credit	305	235	75
Health:			
Exclusion of employer contributions for medical insurance premiums and medical care	14,050	15,330	16,380
Deductibility of medical expenses	3,615	3,925	4,175
Exclusion of interest on State and local hospital bonds	560	680	310
Deductibility of charitable contributions (health)	1,390	1,360	1,345
Income security:			
Exclusion of social security benefits:			
Disability insurance benefits	860	915	910
OASI benefits for retired workers	8,845	9,980	10,525
Benefits for dependents and survivors	1,735	1,915	1,970
Exclusion of railroad retirement system benefits	365	380	370
Exclusion of workmen's compensation benefits	2,730	3,100	3,495
Exclusion of special benefits for disabled coal miners	90	95	90
Exclusion of untaxed unemployment insurance benefits	1,985	2,060	2,710
Exclusion of disability pay	170	155	145
Net exclusion of pension contributions and earnings:			
Employer plans	23,390	25,765	27,500
Plans for self-employed and others	2,170	2,560	3,760
Exclusion of other employee benefits:			
Premiums on group term life insurance	1,840	1,900	1,895
Premiums on accident and disability insurance	100	100	100
Income of trusts to finance supplementary unemployment benefits	15	20	20
Additional exemption for the blind	30	30	30
Additional exemption for elderly	2,250	2,355	2,370
Tax credit for the elderly	130	135	135

Table G–2. REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" BY FUNCTION—Continued

(In millions of dollars)

Description	Fiscal years		
	1981	1982	1983
Deductibility of casualty losses	775	800	850
Earned income credit [2]	610	555	495
Exclusion of interest on State and local housing bonds for rental housing	435	485	535
Deduction for motor carrier operating rights	*	140	75
Deduction for certain adoption expenses	10	10	10
Veterans benefits and services:			
Exclusion of veterans disability compensation	1,255	1,360	1,380
Exclusion of veterans pensions	95	85	90
Exclusion of GI bill benefits	200	175	145
General government:			
Credits and deductions for political contributions	100	80	80
General purpose fiscal assistance:			
Exclusion of interest on general purpose State and local debt	5,855	6,685	7,505
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	19,085	20,395	21,530
Tax credit for corporations receiving income from doing business in United States possessions	1,120	1,200	1,285
Interest:			
Deferral of interest on savings bonds	−270	−80	50

*$5 million or less. All estimates have been rounded to the nearest $5 million.

[2] In addition, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts of $55 million in 1981, $35 million in 1982, and $55 million in 1983.

[3] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays is: 1981, $1,320 million; 1982, $1,255 million; 1983, $1,180 million.

Provisions Previously Designated "Tax Expenditures"

Table G–3, which follows, shows "revenue loss" estimates for current provisions of the Internal Revenue Code that were designated as involving "tax expenditures" in last year's budget, but which should be considered part of the reference tax structure rather than as special exceptions to it.

Table G–3. REVENUE LOSS ESTIMATES OF PROVISIONS PREVIOUSLY DESIGNATED "TAX EXPENDITURES"

(In millions of dollars)

Description	Fiscal years		
	1981	1982	1983
International affairs:			
Deferral of income of controlled foreign corporations	480	520	560
Natural resources and environment:			
Exclusion of payments in aid of construction of water, sewage, gas and electric utilities	35	30	45
Agriculture:			
Deductibility of noncash patronage dividends and certain other items of cooperatives	525	545	560
Exclusion of certain cost-sharing payments	70	60	50
Commerce and housing credit:			
Reduced rates on the first $100,000 of corporate income	6,555	5,680	6,280
Education, training, employment, and social services:			
Exclusion of scholarship and fellowship income	450	465	415
Income security:			
Exclusion of public assistance benefits	450	445	430